

OUTSOURCING TO
C H I N A



THE OPPORTUNITIES.

In the past 20 years, outsourcing — and especially offshore outsourcing — has evolved from a niche business tool into a mainstream business practice and an industry in its own right.

As with any project affecting a company's core operations, outsourcing needs to be handled carefully since it involves handing over vital business processes, such as technology support, to a third-party expert to run. But, when executed properly, outsourcing can yield significant cost savings, increased efficiency, greater profitability, and other benefits that can make a company more competitive. Outsourcing can also protect a company by shifting risk to a third party while permitting the company to leverage outside expertise and resources and concentrate on its own core business.

Outsourcing is also increasingly used to help consolidate global businesses, either as part of routine administrative streamlining, or after corporate mergers and acquisitions. By outsourcing common business processes and IT systems across different countries or regions of an organization's operations, businesses can achieve a higher degree of global standardization.

Why Now?

It's all about costs. In previous recessions, outsourcing activity has actually increased. In times of extreme economic duress, all companies are looking for ways to reduce costs significantly and quickly, and to streamline operations, whether to survive what could be a protracted recession, or to take full advantage when finally emerging from it. Not surprisingly, companies are turning to outsourcing as a means to achieve these ends.

Whereas, over the past five years, outsourcing has been touted as a means not only of cutting costs but also of transforming a business or improving the quality of the functions being outsourced, the recent economic collapse has put such outsourcing rationales on the back burner. Today's outsourcing deals are intensely, singularly concerned with reducing headcount and saving money — and the sooner the better.

Asia: The Home of Offshoring.

Offshore outsourcing from a high-cost to a low-cost country brings with it the potential benefit of significantly lower operating costs — as long as you properly deal with the extra risks that come from managing services and a service provider in another country.

Asia is home to three of the four major offshore outsourcing destinations on the planet: India, the Philippines and China (the fourth is Ireland), which combine to account for around 75% of the global offshore outsourcing market by revenue.

Each country focuses on a different segment of the market. India is the most mature of the three; it began to dominate the offshore outsourcing market in the mid-1990s (although outsourcing began in India as early as the 1980s), and India now offers a wealth of outsourcing services to cover just about anything you can imagine, but focuses on low-end to mid-range business process outsourcing (“BPO”) services such as call centers (or so called “contact support”), and the whole range of low- to high-end IT outsourcing (“ITO”) services. This includes everything from data entry through testing, maintenance, and software localization, to applications development and maintenance (“AD&M”), both for non-business critical functions, and business-critical functionality as well. The Philippines entered the BPO market later in the 1990s, and is now almost completely focused on that market.

China has really only entered the outsourcing market seriously in the last five years, but is already posing a threat to the existing order as with anything that the PRC government supports. China has focused on becoming a leader in AD&M and ITO service offerings. Conversely, it only services around 3% of the global offshore BPO market, trailing India (with 51%), the Philippines (21%), and Ireland (7%).

Malaysia, Thailand, Vietnam, and Singapore are all home to thriving outsourcing service providers as well, but not on the scale of the “Big Three.”

The Challenges.

It is critical to understand that undertaking any form of business transaction in China presents unique challenges as a result of both cultural and regulatory factors. Outsourcing is no exception to this rule. While familiarity with English or U.S. law based service agreements or offshoring arrangements to India is undoubtedly helpful, it is ultimately no substitute for on-the-ground experience of how projects work in China – and, indeed, how “the system” works generally in China. Most companies find that experienced locally-based counsel are essential to help conduct appropriate diligence on the service provider, establish the most efficient structure, and avoid the often less-than-obvious regulatory pitfalls whilst also negotiating the contract and focusing on the commercial drivers necessary to make the project a success.

There are several key challenges which need to be addressed in a China outsourcing, including:

Language

In comparison with India, China has a more limited pool of English speakers, with approximately 15% of the population possessing basic proficiency. This has restricted the growth of English language call center facilities in China, and can also result in numerous challenges in the negotiation and implementation of all other types of outsourcing arrangements.

Although, as a matter of law, contracts do not have to be in Chinese to be effective, in practice any documents which need to be filed with the PRC authorities will only be accepted if they are written in the Chinese language. Bilingual technical and legal support in negotiations can not only improve efficiency, but also will generally help avoid the risk of misunderstandings or ambiguous translations that can otherwise result in operational delays, mistakes, and associated transactional costs related to simply managing the flow of information and instructions.

Due Diligence

Outsourcing projects typically involve strategically important or sensitive functions and it is critical to obtain a thorough understanding of the background, bona fides, qualifications

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Why China?

“China is the new India” has been the mantra of most analysts for some time now, and it is as true as ever. It is no longer a question of whether China will evolve into a major offshore outsourcing destination, but when. It’s no longer in doubt that a company looking to outsource offshore should consider China as a destination; China should already be considered as a genuine alternative to the other more obvious choices. In fact, there is even a burgeoning market in “sub-offshoring” from India to China as the large India-origin service providers themselves look to use China in order to offset cost inflation in India.

China has many of the same advantages as India, such as *scalability*, with an incredibly vast labor pool; *competitive labor cost*, with an unparalleled cost arbitrage of between 10-20% lower (overall) cost than India; and the *low cost of doing business*. There is also established infrastructure in place in China’s many major

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Why China?

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cities, and although Beijing and Shanghai are still home to China's 3,000-odd service providers, certain other cities — all with populations in excess of one million — are also beginning to make waves in the outsourcing industry, such as Shenzhen, Chengdu, and Dalian.

In fact, Dalian and other cities in the north of China already have a niche market offering outsourcing services to their neighbors Japan and South Korea, where the advantages of many local people speaking Japanese, the time-zone proximity, short flight times, and cultural similarities have all ensured that China is already the leading outsourcing destination for Japan and Korea; around one-third of China's outsourcing revenue comes from Japan and South Korea, with around 45% from U.S./U.K. companies and approximately 20% from the domestic market.

Last, but not least, there is strong government backing for the outsourcing industry in China.

The Challenges.

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and resources of the proposed service provider. Unlike the U.S., there are only limited private business information organizations in China, and it is therefore usually necessary to independently undertake direct due diligence in the areas of financial stability and corporate establishment, as well as land use rights, ownership of assets, and compliance with employment requirements. As there are limited official sources of information about companies in China, it is commonplace to require the service provider to provide the necessary official documents showing the service provider's due incorporation and license to engage in business. There are also industry-specific licenses and qualifications, such as a *Certified Software Enterprise* certificate, that can provide further evidence that the service provider satisfies certain minimum requirements with respect to staffing, hardware, and experience.

The Regulatory System – General

There are no specific “outsourcing regulations” in China. Rather, outsourcing is subject to an overlapping and potentially inconsistent set of industry and activity-specific regulatory regimes. Typically, the relevant written regulations are drafted in very high-level language which gives the supervising authorities substantial flexibility as to the regulations' implementation. Unfortunately, as a result, simply reading the regulations is not particularly helpful and, in order to understand properly how the rules are applied in practice, a combination of experience and close working relationships with the relevant government departments is essential.

The regulatory regime in the sensitive telecommunications sector provides one particularly pertinent example that can be relevant to parties wishing to set up captive data centers or “software as a service” facilities in China. Such activities generally require permits under the *PRC Telecommunications Law* that are typically not available to foreign-owned entities. However, complex but well-tested nominee structures have evolved in the market to enable the provision of such services with the tacit approval of the regulator.

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The Challenges.

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Technology Import Regulations

Many outsourcing transactions involve the transfer or license of intellectual property rights (“IPR”), technology, software, or know how to the service provider (and in some cases, for example AD&M, may involve a transfer of IPR back to the customer). Such transfers are governed by the *PRC Administration of the Import and Export of Technologies Regulations* (“TIE Regulations”), which are mandatory and cannot be excluded by the contract terms or choice of governing law in the outsourcing agreement.

The TIE Regulations classify technology into three categories: unrestricted, restricted, and prohibited. Catalogues of restricted and prohibited technology are published by the Ministry of Commerce (“MOFCOM”). Contracts for the import/export of restricted technology require approval from MOFCOM while those related to prohibited technology are simply unlawful. Although most outsourcing transactions will involve unrestricted technology, and would therefore only require registration, the customer should obtain confirmation as to whether restrictions apply and require the service provider to obtain any necessary approvals.

While registration is a fairly simple process, the TIE Regulations do require the importing party (*i.e.*, the customer) to give rather onerous warranties regarding the fitness and completeness of the imported technology, as well as non-infringement of third-party IPR. Moreover, the TIE Regulations place severe (and potentially unpalatable) limits upon the customer’s ability to restrict the service provider’s ability to make and use improvements to the imported technology. Attempts to circumvent these regulatory requirements (for example, by inclusion of the kinds of disclaimers commonly seen in domestic U.S. outsourcing agreements), or the failure to register a technology contract, may result in difficulties in enforcing the contract against the Chinese party. In order to mitigate these issues, Chinese outsourcing arrangements (particularly in respect of development work) are often carefully structured so as to utilize offshore affiliates and collateral contracts.

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The Challenges.

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Protecting Your Intellectual Property

As recent high-profile cases have demonstrated, foreign companies looking to outsource sensitive functions to China (in particular development work) would be well advised to take steps to protect their IPR in order to mitigate the risks of unauthorized disclosure and counterfeiting. High levels of employee churn amongst outsourced service providers (particularly in the AD&M field) coupled with limited cultural awareness of the importance of proprietary information can tend to exacerbate this problem. While there is no “magic bullet” available which will ensure the protection of a company’s IPR in China, there are several steps which can and should be taken in conjunction with each other as part of a unified strategy to minimize the risk.

Firstly, it is important to note that the PRC IPR enforcement regime is focused heavily upon registered rights, so local registration of IPR within China can be helpful. It is also necessary to register certain forms of copyright work — most notably computer software — as well as patent and trademark filings, with the PRC authorities. It’s also sensible to ensure that the outsourcing agreement includes appropriate contractual restrictions regarding use and disclosure.

However, it is critical that the company take all possible practical prophylactic measures to protect its IPR, rather than depending on the PRC legal system to protect the company’s rights after the fact. Proper compartmentalization and practical document control can be worth far more than a contractual right which may be difficult to enforce — *i.e.*, an ounce of prevention is often worth a pound of cure. In order to obtain any protection for trade secrets under the *PRC Anti-Unfair Competition Law*, it will be necessary for the customer to take “measures” to keep the information regarding the company’s technology confidential. A number of common sense, practical measures exist. In particular, the customer should ensure that the outsourcing agreement contains a full and detailed information security schedule that provides for the marking of documents and appropriate physical and logical controls over access.

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The Challenges.

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The Outsourcing Agreement

There are several unique local factors which make it unwise simply to transplant an existing standard form U.S.- or India-based outsourcing agreement for use in a China deal. In addition to general and industry-specific regulatory requirements (see above), Chinese law does not recognize certain basic concepts such as liability caps. Moreover, phrases such as “consequential loss” and “special damages” are not recognized terms, and care should be taken over their use. Familiar clauses such as restrictive covenants regarding employment or default interest on late payments may be unlawful unless couched in accordance with local Chinese regulations.

As a practical matter, when negotiating the outsourcing agreement, it will be wise to check in advance that the representative of the service provider has the authority to make the necessary decisions, which one would probably take for granted in other parts of the world. It is not unheard of for offshore parties to negotiate for weeks before discovering that the representative of the Chinese party does not have the requisite authority, and negotiations then have to be re-opened with his or her superior, perhaps after key concessions have already been made.

Counter-intuitively, dispute resolution by litigation in the U.S. will generally be unhelpful in a China outsourcing project. In the absence of any reciprocal enforcement treaties, Chinese courts will generally not enforce foreign judgments; rather, the company will end up with an expensive, slow, and not necessarily unbiased re-trial on the merits of the case. However, China is a party to the New York Arbitration Convention and its courts are required to enforce overseas arbitral awards. In practice, awards made under arbitration in Hong Kong are less likely to run into procedural issues preventing enforcement in China than those made in the U.S. or elsewhere.

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Representative Matters

How We Can Help.

The group's specialist partners have over twenty years' experience advising on outsourcing transactions in China including the following significant examples:

Japanese Investment Bank.

Engaged by one of the top-tier Japanese investment houses to act for it generally on technology matters in the APAC region, and globally, including the negotiation of numerous global sourcing contracts following a major acquisition in late 2008. Also represented the Bank in respect of a major IT outsourcing project to China, followed by the acquisition of the outsourcing service provider by the Bank.

U.S. Insurance Company.

Acting for a major U.S. insurance company in connection with the cross-border outsourcing of software development work for its Japanese business to third-party service providers in Shanghai.

Standard Chartered Bank.

Advised Standard Chartered Bank in respect to the outsourcing of its global back-office IT systems to Atos Origin, including conducting an extensive due diligence exercise in respect of some 600 existing contractual relationships and undertaking follow-up work in order to update the relevant documentation with the vendors concerned.

As one of the very few dedicated teams of specialist technology and outsourcing lawyers located and operating on the ground within China, Morrison & Foerster's China Technology Transactions Group is able to offer an unparalleled combination of local regulatory knowledge and international commercial experience. In particular, we offer due diligence support from our Beijing and Shanghai offices, an in-depth understanding of industry norms and market-driven structures acceptable to Chinese regulators, and expertise in relation to local intellectual property laws and enforcement arrangements. In addition to U.S.-qualified attorneys, the team includes PRC-qualified lawyers together with Hong Kong solicitors, enabling us to advise on a wide variety of outsourcing arrangements.

The group is backed up by a dedicated team of legal translators who help ensure that Chinese versions of outsourcing agreements and documents for official filing are prepared efficiently and in accordance with the terminology expected by the Chinese authorities.

The group offers a unique one-stop shop, marrying deep local knowledge with international best practice, for complex cross-border technology transactions, and can bring to bear specialist local counsel in Hong Kong, Beijing, and Shanghai, backed up by a wealth of international experience from over 100 U.S.- and U.K.-qualified technology attorneys located in the region and worldwide in major technology centers, including Tokyo, California, London and New York.

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Representative Matters

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Standard Chartered Bank.

Appointed to SCB's Hong Kong technology panel (as we have been for more than 10 years), and advised on various projects including the end-to-end outsourcing of its entire ATM network in Hong Kong. We also advised this international bank with respect to several projects, including the outsourced services arrangements for a major new call center facility in Shenzhen, China.

Gartner Consulting/Hong Kong Hospital Authority.

Together with Gartner, advising the Hong Kong Hospital Authority (HKHA) on the outsourcing of its ERP systems.

SCB Japan.

Represented SCB Japan in respect of a three-year deal to outsource its entire technology back-office and transaction processing operations to Fujitsu.

Securicor Hong Kong.

Advised the client in relation to the provision of outsourced ATM and cash transactional services for Citic Ka Wah bank.

Jardine Matheson.

Advised the client in respect of the cross-border outsourcing of its Hong Kong Pizza Hut telephone call center to the PRC.

Advanta.

Advising this U.S. bank on an agreement for the outsourcing of certain research and development activities to China.

What Others Say About Us

The China Technology Transactions Group is led by partner Gordon Milner who is recognized by *Chambers* as leading lawyers for technology and outsourcing in Hong Kong and China. The group was recently named “China Telecoms, Media and Technology Firm of the Year 2009” by *Asian Counsel*. *Asia Pacific Legal 500* recognizes the group in the first tier for technology work in China and, since 2006, has ranked us as the only law firm in tier one for technology work in Hong Kong. *Chambers* ranks the firm as a Tier One law firm for technology work in Hong Kong and China. *PLC Which Lawyer?* and *Global Counsel* both highly recommend the firm for IT and Telecoms in Hong Kong and China.

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